3/23/87 B5350-3A

MANUFACTURERS HANOVER

Economic Report

March 1987

Commentary on Pertinent Economic Issues

Irwin L. Kellner
Chief Economist

Manufacturers Hanover Economics Department 17/270

Deficits And The Dollar

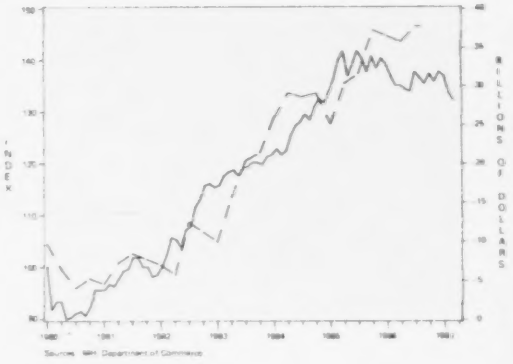
Over two years have passed since the U.S. dollar began to decline in the foreign exchange markets, and yet our trade deficit has continued to grow. Not surprising, the passage of legislation to close this gap has emerged as the number one item on Washington's agenda. Elected officials are feeling intense pressures from their constituents, and it's not hard to see why. For the last three years, the widening trade gap prevented reasonably good growth in domestic spending from being translated into similar strength in output, as people purchased more and more foreign-made goods. The gross national product adjusted for inflation last year grew one percentage point less than it would have if the trade gap had merely stabilized. Both business failures and the jobless rate remained high.

It will be very tempting for the politicians to take a heavy-handed approach to trade, for they are seeking quick results. They want to slow imports while boosting exports, and they are prepared to use tariffs, quotas or surcharges to achieve these objectives. In addition, you may expect to hear more about fair trade and reciprocity, as Washington seeks to prod others either to stop subsidizing their exporters, and/or to open their markets to more of our exports. However, correcting our trade imbalances by legislation is fraught with risks. For one thing, while no one would maintain that we have free trade today, any omnibus trade bill would invite retaliation by others, leaving all of us worse off. For another, any generalized legislation would overlook the many reasons why our trade deficit remains large.

The Strength Of The Dollar . . .

In my opinion, the number one culprit is the continued strength of the dollar. The Manufacturers Hanover trade-weighted dollar, which is adjusted for inflation, has declined by less than ten percent over the last two years (Chart I). By contrast, the Federal Reserve's measure is off by more than 35 percent. One of the reasons our index shows such relative dollar strength is that it contains more currencies than the Fed's—and the dollar hasn't declined as much against these other currencies as it has against the major units. But even where the dollar *has* fallen a lot, exporters from these countries are not raising their selling prices by as much as their currencies have gone up.

CHART I
REAL MH TRADE-WEIGHTED DOLLAR <JAN. 1980=100> (LINE)
VS. MERCHANDISE TRADE DEFICIT BOP BASIS (DASH)



Perceived differences in product quality also play an important role in the deficit issue. Right or wrong, many people think that certain foreign-made goods are better than ours and they're willing to pay more to get them. Besides this, in a number of instances, there is virtually no comparable domestic product. Videocassette recorders are a good example: They are for the most part made in Japan and other East Asian countries. In other cases, such as oil, we don't make or produce enough to satisfy our domestic demand.

. . . Along With Other Factors . . .

Reacting to the initial rise in the value of the dollar—not to mention a more favorable labor climate—many U.S. companies have moved their operations offshore. To the extent they export, we've lost them, and when these goods are brought back here, they are recorded as increased imports. Additionally, the march of technology, by simplifying the production and assembly of a growing number of items, has enabled countries with the lowest labor costs to capture these markets. These tend to be the developing countries from the Pacific Basin and from Latin America with whom our

Copyright 1987 Manufacturers Hanover Corporation 270 Park Avenue, New York, NY 10017

bilateral trade deficits continue to grow. On another front, the Commerce Department alleges that many U.S. companies don't have much of an interest in exporting. They don't want to take the time and trouble to learn the customs, laws and languages of other countries—as evidenced by the protracted decline in exports' share of GNP.

Let's not forget the reaction of the developing countries to their debt burdens. In an effort to convert their own trade deficits to enough of a surplus for them to service their debts, most such nations have slashed imports and pushed exports—especially of farm products and raw materials. Unfortunately, such actions, albeit necessary, have adverse as well as favorable results. For example, our trade surplus of $7 billion with Latin America in 1981 turned into a deficit of about $12 billion last year, while our farmers are suffering from the worst combination of falling prices and depressed land values since the 1930s.

. . . Calls For A Variety Of Strategies . . .

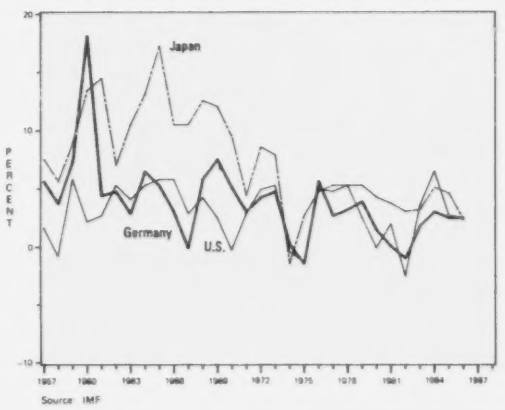
These varied factors call for not one approach—but several different strategies to shrink our trade deficit. To be sure, Washington should not abandon its theme of reciprocity. Free trade means fair trade: others should not give their domestic producers an unfair advantage by subsidizing their exports or restricting imports unless they are prepared to face the same thing here.

Then there is the value of the dollar. It would appear that the buck will have to fall further against some of the currencies where it has already declined substantially in order to force exporters from these countries to raise their selling prices enough to dampen U.S. demand. The dollar will also have to fall against the currencies where it has declined very little—or even risen.

This contrasts with the view taken by the finance ministers of the major industrial countries at their recent meeting in Paris. Their communique said in part that the dollar was appropriately valued, and that it should remain close to present levels. While not specifying exact targets—or even acknowledging that they had specific ranges in mind—they agreed that the dollar had fallen enough. They did not say they would intervene—but they did not say that they wouldn't. What is more, they promised to try to coordinate their economic policies. This is because they want the fundamentals which determine currency rates in the long run—inflation, growth, current account balances and real interest rates—to converge, thus supporting their efforts to stabilize the major currencies.

In my opinion, this is easier said than done. As you can see from Chart II, annual rates of growth of the economies of the United States, Germany and Japan have varied all over the lot in the past 20 years. Convergence was rare—and accidental, at that. It is hard to imagine that the major countries are ready to coordinate their economic policies now, since the U.S. and Canada, to name two, cannot even agree on how to enter into a free trade zone. Indeed, history teaches us that nationalistic considerations almost always override broad international objectives. Only when one nation is strong enough to impose a solution on the rest do major international problems get solved. While the U.S. was able to do this right after World War II, it is evidently unable to do so today.

CHART II
GROWTH IN REAL GNP OF SELECTED INDUSTRIAL COUNTRIES



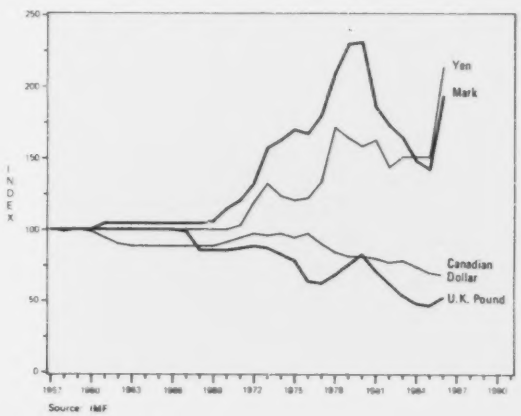
Source: IMF

In addition, free markets will always have the potential for volatility. This applies whether the markets consist of foreign currencies, commodities, stocks or interest rates. And, since currencies began floating in 1973, there is no longer any way that any one central bank—or even a group of them—can impose stability, since the markets are now many times larger. Chart III shows how volatile the major currencies have been since the Bretton Woods fixed-exchange rate system ended in 1971.

Furthermore, our calculations suggest that the U.S. dollar remains overvalued. Therefore, stabilizing it at current levels will not do much to reduce our trade deficit. We base this belief on the theory of Purchasing Power Parity. This compares items that can be bought for a dollar in the United States with their cost overseas in local currencies. Right now, for instance, it would appear that the U.S. dollar has fallen so swiftly compared with the West German mark that it is now undervalued against this key currency. This can be seen from the fact that it takes about two D-marks to buy in Germany what one dollar buys in the United States, although the exchange rate at mid-month was about 1.85 marks to the dollar.

But Germany is only our fourth largest trading partner. Against the currency of Japan, our second largest trading partner, the dollar remains overvalued—notwithstanding what seems to be a decline nearly equal to that registered against the mark. This is because all it takes is 150 yen to buy in Tokyo what one dollar buys in the United States, while the exchange rate at mid-month was nearly 153 yen to the dollar. The U.S. dollar is even more overvalued against the currency of Canada—our largest trading partner. It costs only about 1.15 Canadian dollars to buy the same goods in Canada that one dollar buys here, while one must give up 1.33 Canadian dollars to obtain a U.S. dollar in the foreign exchange markets. The dollar is also overvalued against the currencies of several Pacific Basin countries. All in all, we estimate that the U.S. dollar at mid-month was still at least 15 percent too strong, when measured against the currencies of our major trading partners.

CHART III
VALUE OF SELECTED CURRENCIES IN U.S. DOLLARS
<JANUARY 1957=100>



Getting back to the other approaches the U.S. might employ to shrink its trade deficit, improving the quality of the goods we produce won't be easy. It will require a commitment on the part of labor and management that is now seen in only a few industries. We must also encourage investments from abroad. This way, we'll be able to overcome the fact that we don't produce certain items, or that some of our companies have set up shop elsewhere. Obviously, we should reduce our reliance on imported oil. A tax would seem to be the answer, and it would have the additional benefit of helping our domestic oil industry get back on its feet. We can't do anything about technological change, but we can concentrate on producing what we're good at, using our natural advantages. This means greater emphasis on those products requiring advanced technology, substantial capital investments, and highly skilled labor.

. . . To Shrink Our Trade Deficit

Washington needs to help industry restore its international competitiveness. Besides education and training, elected officials should consider changing the tax code so that savings and investment are encouraged—not discouraged as they are now. Other countries need to grow faster, otherwise they won't be able to import more from us, no matter what our exporters do. This is true also for the developing countries, whose debt burdens must be lightened enough to allow them to increase their imports from the U.S.

Let's not forget our other deficit—the red ink in Washington's budget. It was responsible for pushing the dollar skyward by forcing interest rates up, thereby attracting foreign money here. If we do manage to reduce our trade deficit without cutting our budget deficit by at least as much, we'll wind up with more problems than we solve, because a lower trade deficit will shrink the amount of funds foreigners have to put into our financial markets. In turn, this would mean higher interest rates if the Federal Reserve doesn't become more accommodative, or more inflation, if it does. ■

What does it take to win?
The race doesn't go just to the swift. All these people can run. The winner is the one with the strength, the commitment, the desire to reach down inside, at exactly the right moment, and break out into the clear.
At Manufacturers Hanover we believe there are parallels between physical and business accomplishment. And we want the world to know we have what it takes to win.

MANUFACTURERS HANOVER

MANUFACTURERS HANOVER

Manufacturers Hanover Corporation
Bank Window, Church St. Station
New York, N.Y. 10015

First Class Mail
U.S. Postage
PAID
New York, N.Y.
Permit No. 5766

208 208032565 C 928 SRIACOCOI
MR. SRI ACQUISITIONS
CONGRESSIONAL INFORMATION
SERVICE, INC.
4520 E.-W. HIGHWAY SUITE 800
BETHESDA, MD 20814